FINANCIAL SECTOR ASSESSMENT

MONTENEGRO

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A joint World Bank-IMF team visited Montenegro during September 1-15, 2015 to conduct an assessment under the Financial Sector Assessment Program (FSAP).[1] This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities, and provides policy recommendations.

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ABBREVIATIONS

AML	Anti-Money Laundering
AQR	Asset Quality Review
ATM	Automated Teller Machine
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
CAR	Capital Adequacy Ratio
CBM	Central Bank of Montenegro
CDD	Customer Due Diligence
CFT	Combating the Financing of Terrorism
CPA	Consumer Protection Agency
CR	Credit Registry
DNS	Deferred Net Settlement
DPF	Deposit Protection Fund
DPL	Deposit Protection Law
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ELA	Emergency Liquidity Assistance
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FMI	Financial Market Infrastructure
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Council
FSSA	Financial System Stability Assessment
GDP	Gross Domestic Product
HQLA	High-Quality Liquid Assets
IASB	International Accounting Standards Board
IDF	Investment and Development Fund
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	Insurance Supervision Agency
ISA	International Standards on Auditing
LCR	Liquidity Coverage Ratio
LOLR	Lender of Last Resort
LTD	Loans to Deposits
MaPP	Macro Prudential Policy
MCI	Microcredit Institutions
MFI	Monetary Financial Institutions
ML	Money Laundering
MOF	Ministry of Finance

NCP	National Contingency Plan
NPC	National Payments Council
NPL	Non-Performing Loan
NSFR	Net Stable Funding Ratio
OMO	Open Market Operation
PEO	Public Enforcement Officer
PEP	Politically Exposed Persons
PIE	Public Interest Entity
PoS	Point of Sale
POS	Public Oversight System
QAR	Quality Assurance Review
QIS	Quantitative Impact Studies
RR	Reserve requirement
RTGS	Real-Time Gross Settlement
SEC	Securities and Exchange Commission
SME	Small and Medium Enterprise
SPV	Special Purpose Vehicle
TF	Terrorism Financing
USD	United States Dollar
WB	World Bank
YOY	Year on Year

EXECUTIVE SUMMARY

The Montenegrin economy has yet to recover from the collapse of the lending boom in 2008. The financial crisis hit asset quality, weakening banks' portfolios. The legacy of pre-crisis rapid increase in indebtedness is adding to banking sector vulnerabilities. The crisis triggered a prolonged period of balance sheet deleveraging, which has translated into a near uninterrupted credit contraction. Slow economic growth and gaps in the legal framework have hampered banks' efforts to reduce the overhang of nonperforming loans (NPLs).

Economic momentum is set to accelerate this year, but risks weigh on the downside. The temporary boost in growth comes at the expense of exacerbating already pronounced public debt-related vulnerabilities. While the lending to the private sector has recently shown signs of recovery, credit growth remains slow. The high degree of private-sector leverage limits prospects for a strong and sustained credit-led recovery.

System-wide solvency and liquidity indicators appear broadly sound, but significant pockets of vulnerabilities exist among domestically owned banks. The financial system is dominated by banks and, in particular, by foreign subsidiaries. Several domestically owned banks have very high NPLs and/or very low provisioning levels; some have received qualified audited reports in recent years. Stress tests indicate that those banks are also vulnerable to shocks, such as protracted economic slowdown, even under the moderate stress scenario. Notable cross-border exposures remain.

The increasing competition and slow economic recovery are weighing on banking sector profitability. While interest rates spreads are still high, the banking sector's persistent weak profitability does not evidence low competition, as argued by the authorities. On the contrary, strong competition in the banking sector is compressing interest rate spreads to levels threatening the survival of some smaller banks with higher funding and operating costs and weaker client base.

Decisive action to deal with weak banks is critical for preserving financial stability. The authorities are advised to develop with high priority, time-bound supervisory action plans, including capital injection by shareholders. An independent Asset Quality Review (AQR) of all banks is recommended to review loan classification and provisioning practices.

While the legal, regulatory, and supervisory frameworks for the banking and insurance sector have markedly improved since the 2006 FSAP, further progress is required. The main areas for banking oversight include: identifying, measuring, and managing nonperforming assets and liquidity risk; reducing credit concentration, operational, and funding risks; strengthening banks' for risk management; and introducing effective consolidated supervision. In insurance oversight, the key policy priorities are moving to a risk-based supervisory approach and gradual introduction of Solvency II.

A number of key shortcomings should be remedied to complement improvements in the framework for NPL resolution. Recently strengthened supervisory requirements should be complemented by reversing the loosening of regulatory standards over the last several years. Banks should raise additional capital in order to absorb NPL losses. The recent Law on Consumer Bankruptcy needs to be amended, as it could negatively affect the collection of existing NPLs and the issuance of new loans secured with mortgages.

The financial safety net should be strengthened. CBM should be confirmed as the resolution authority for the institutions under its supervision. A number of essential resolution powers, such as establishing a bridge bank, should be made available to CBM. CBM should start bank-specific resolution planning. The Deposit Protection Fund (DPF) should be authorized to fund resolution measures and needs to be more closely integrated in crisis preparedness mechanisms. A credible and transparent public backstop is needed to deal with systemic cases in the absence of private sector-funded resolution. Emergency liquidity assistance should be brought under a single framework and follow best international practice. Macro prudential policies and systemic liquidity management should play a central role in the absence of independent monetary policy and to complement sound fiscal management.

Macro prudential framework and systemic liquidity management should play a central role in the absence of independent monetary policy and to complement sound fiscal management. In preparation for Basel III, sound liquidity risk management standards as the first line of defense against liquidity pressures should be prioritized. A macro prudential framework should be established and, over time, made fully operational, underpinned by broader and more focused cooperation among the relevant agencies, under auspices of the FSC.

The CBM-managed payment and settlement systems are generally efficient. Some adjustments are needed to minimize any residual liquidity risks, such as facilitating the automatic transfer of balances from the reserves account to the settlement account. The CBM oversight function should be strengthened through the formulation of an oversight policy framework along with improvements to interdepartmental communication and exchange of information.

The growth of the financial sector has contributed to greater access to finance for individuals and SMEs, but a number of weaknesses in the regulatory and enabling environment need to be addressed. Leasing and factoring companies should be brought under CBM oversight. Concerns about excessive interest rates and harmful market practices call for a strengthened financial consumer protection framework. In particular, disclosure of loan terms by all credit providers should be enhanced as an alternative to envisaged interest rate caps. Improvements in credit and corporate financial reporting are called for to reduce information asymmetries. Public support instruments such as the Institutional Development Fund should be improved to ensure the effectiveness and efficiency of their interventions and avoid market distortions.

Table 1: Montenegro: FSAP Key Recommendations

Recommendations and Authority Responsible for Implementation	Term*
Financial System Resilience	
Prepare and implement time-bound supervisory action plans for vulnerable banks (CBM; ¶15)	I
Conduct Asset Quality Review for all banks to determine adequacy of provisions (CBM; ¶16)	I
Financial Oversight	
Introduce macroprudential mandate and pertinent policy toolkit (MOF/CBM/FSC; ¶25)	MT
Tighten prudential norms for identification and classification of nonperforming assets (CBM; ¶26)	I
Improve the regulatory and supervisory framework for liquidity and credit risks (CBM; ¶27)	NT
Introduce effective consolidated supervision (CBM; ¶31)	NT
Incrementally implement Solvency II in insurance sector (ISA; ¶37)	NT
Implement risk mitigation measures to minimize liquidity risks in the RTGS system (CBM; ¶40)	I
Strengthen CBM's oversight function over FMI (CBM; ¶41)	NT
Finalize national risk assessment and ensuing AML/CFT action plan (CBM; ¶41)	NT
Resolution of NPLs	
Enforce consistent application of tightened asset classification and provisioning standards, and require capital headroom to absorb losses due to expedited NPL resolution (CBM; ¶45)	I
Strengthen the voluntary debt restructuring framework (MOF; ¶48)	I
Amend personal bankruptcy regime to clarify creditors' rights regarding loans secured by mortgages (MOFJ; ¶49)	I
Financial Safety Net	
Set strict and objective criteria for determining systemic importance of banks to determine eligibility for capital support (CBM/MOF; ¶55)	I
Strengthen resolution funding options (MOF; ¶58)	NT
Organize a dedicated resolution unit within CBM and initiate bank-specific resolution planning, starting with weakest CAMEL-rated banks (CBM; ¶56)	I
Implement risk-based contributions and shorten pay-out term (DPF/MOF; ¶61)	NT
Strengthen FSC's focus on its crisis preparedness and management mandate (FSC; ¶64)	NT
Financial Sector Development Agenda	
Strengthen the legal and supervisory framework for leasing, factoring, and other nonbank entities providing credit, with the view to promoting a level playing field (CBM; ¶66)	NT
Enhance market conduct supervision and disclosure of loan terms by all entities providing credit (CBM/MOE; ¶67)	I
Strengthen the IDF's oversight, corporate governance and business model (MOF/CBM/IDF; ¶70)	NT
Expand the coverage of information collected and distributed by the credit registry (CBM; ¶74)	NT
Establish a National Payment Council and implement a comprehensive national strategy to increase usage of retail electronic payment instruments (CBM; ¶72)	NT
Adopt new accounting and auditing legislation consistent with EU norms (MOF; ¶76)	I
Introduce simplified financial reporting standards for SMEs and improve verification and publication of reported financial statements by tax authorities (MOF; ¶76)	NT

* I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years

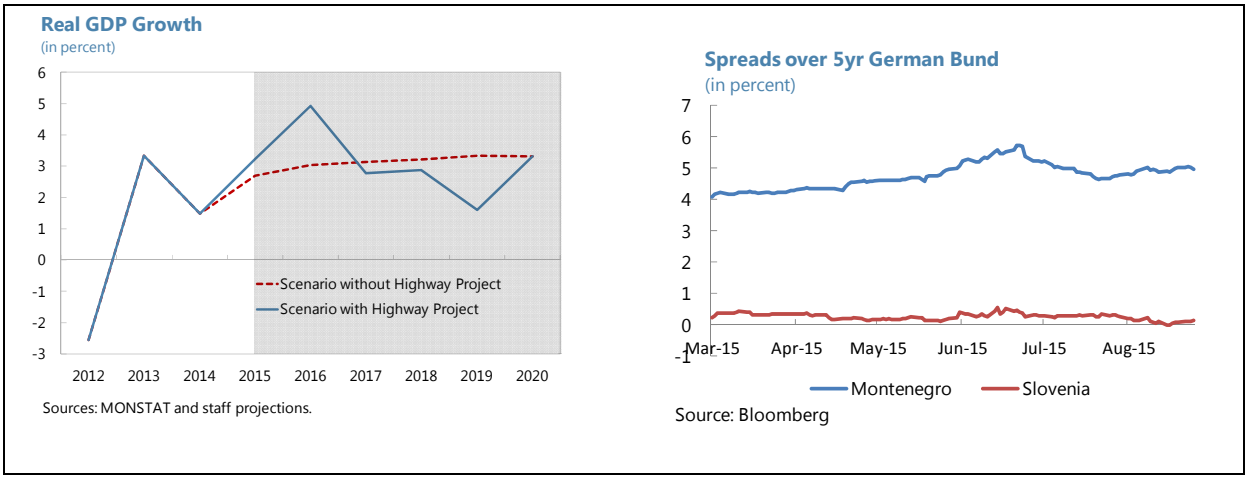
I. MACRO-FINANCIAL SETTING AND FINANCIAL SYSTEM STRUCTURE

A. Macroeconomic Background

1. Montenegro's growth potential has been hampered by high and rising public debt, a large stock of NPLs, and bank deleveraging that collectively impedes investment and disrupts credit channels. In the run-up to the 2008 crisis, sizable capital inflows fueled a demand boom and imbalances, including reckless bank lending, a housing bubble, and rapid increase in public and private debt (Appendix I). The burst of the asset bubble gave rise to a sharp increase in NPLs and deteriorating bank profitability.

2. Economic activity has accelerated in 2015 as large infrastructure projects move ahead, but risks weigh on the downside (Figure 1). The capital-intensive growth agenda, including the costly highway project (23½ percent of 2014 GDP), should boost growth in the near and medium-term, but it comes at the expense of exacerbating already pronounced public debt-related vulnerabilities. Large, general government financing needs (averaging nearly 10 percent of GDP during 2016-20) are an important source of macroeconomic risk. The economy's narrow production base and rigid labor market reduce the capacity to absorb external shocks and rapidly rising public debt constrains policy space. Lax fiscal discipline could ultimately increase funding costs and lending premiums (Figure 1).

Figure 1. Montenegro: Moderate Growth in a Still Weak Environment



3. Since the crisis, slow credit growth has been a drag on economic growth. Reliance on foreign direct financing of investment has increased but empirical work suggests that increased bank lending can provide an important boost to medium-term growth. After almost seven years of near uninterrupted contraction,[2] lending to the private sector has showed signs of recovery during 2015; lending to the private sector has increased by 4½ percent (households and the corporate sector expanded by 2.8and 6.5 percent, respectively), year-to-date in 2015. However, the overall high degree of private-sector leverage is likely to limit the prospects for a strong and sustained credit-led recovery.

B. Crisis Experience and Policy Responses

4. The economy has yet to fully recover from the collapse of the lending boom, as balance sheet weaknesses and bank deleveraging have hampered economic growth. In the run-up to the 2008 crisis, sizable capital inflows fueled a demand boom and imbalances, including reckless bank lending, a housing bubble, and rapid increase in public and private debt. The bursting of the asset bubble resulted in a large stock of NPLs, deteriorating bank profitability, and significant debt overhang that has contributed to a sustained contraction in credit and weak investment.

5. In the run-up to the crisis, policy actions to address the lending boom had limited results, albeit the blanket deposit guarantee may have eased deposit outflows. By late 2007, the CBM introduced stricter rules for asset classification and provisioning—which were relaxed during the crisis—and increased the capital adequacy ratio (CAR) by 2 percentage points to 10 percent. In early 2008, temporary bank-specific ceilings on credit growth were introduced. Furthermore, the reserve requirement (RR) base was broadened to include public sector deposits and the RR rates on certain deposits were increased. In late 2008, the government guaranteed all bank private deposits to reverse deposit outflows.

[2] Gross loans to households and the corporate sector have contacted by 10½ percent and 34 percent of GDP respectively since their pre-crisis peak in 2008.

C. Financial Sector Structure

6. Banks dominate the financial system and account for about 90 percent of system assets, equivalent to about 93 percent of GDP as of June 2015. With 14 banks operating in Montenegro, up from 11 in 2013, there is scope for sector consolidation. The sector comprises mostly foreign subsidiaries holding 79 percent of the sector's assets. Banks' assets are concentrated in lending products (60 percent), with most of the lending in the trade sector and households (mostly mortgages), each representing about 38 percent of total loans. Loans to nonresidents represent 18 percent of the total. Foreign deposits represent about 20 percent of the total deposits.

7. The insurance sector grew steadily at an average annual rate of 3 percent in the past five years. Total premium has kept pace with the growth of the economy and remains at 2 percent of GDP. The life insurance sector is very small: six life insurers took in EUR 12 million of premium in 2014, insuring less than 10 percent of the population. The non-life insurance sector is predominantly compulsory motor third-party liability insurance. Nine of the 11 insurers are foreign subsidiaries, writing 95 percent of total premiums.

8. The rest of the nonbanking financial system plays a minor role. While the nascent stock exchange's market capitalization is significant, the turnover is very low and the bond market is thin. The total size of the five micro-credit institutions (MCIs) is 2 percent of GDP with assets slightly over 1 percent that of banks. The leasing market is small and declining since the crisis. The number and value of leases has been also declining and stood at 0.4 percent of GDP at end-2014—below regional and income group averages.

II. FINANCIAL SYSTEM RESILIENCE

A. Financial Soundness

9. The financial crisis hit asset quality, which weakened banks' portfolios; and rapid pre-crisis increase in private indebtedness raised banking sector vulnerabilities (Figure 2). Sector NPLs are high at 15.5 percent of total loans at end-August 2015, down from the peak of 25.3 percent in 2011.[3] NPL ratios vary widely among banks from 5.5 percent to 35 percent in June 2015. Regulatory provisions, in turn, are slightly above 70 percent of reported NPLs—slowly increasing since 2010–11. Here, too, significant variations exist across banks, reflecting potential weaknesses in the enforcement of provisioning rules as well as banks' reluctance to provision due to low profits.

10. Banks' reported capitalization appears adequate overall, though with significant variations. The aggregate tier I capital ratio is about 14 percent with the CAR at close to 16 percent, compared to the regulatory minimum of 10 percent, albeit with wide differences (the highest NPL ratio being 35 percent and the lowest among long-established banks 7.4 percent). Nevertheless, some banks could have CARs below the regulatory minimum after provisioning adjustments.

11. The banking sector's profitability continues to be very weak, with an aggregate return on assets (ROA) of 0.5 percent and return on equity (ROE) of 3.4 percent in June. Interest rate spreads on new loans[4] have declined significantly, putting additional pressure on bank profitability. The small market and increasing competition partly explain the high overhead expenses-to-core income ratio, which, in June, was 76 percent for the sector, with five banks above 100 percent.

[3] Excluding special purpose vehicles established by some foreign-owned banks in Montenegro. The SPVs are owned and supervised by the parent banks.

[4] Interest rate spread is defined as the difference between the weighted average effective lending and deposit interest rates.

12. Bank liquidity is ample. Banks have reduced the loans-to-deposits (LTD) ratio since the crisis to just above 100 percent, albeit with wide heterogeneity across banks. The share of extra liquidity held with CBM—above the required reserves—is high, constituting about 80 percent of the required reserves, reflecting possibly higher precautionary balances, sluggish credit demand, increased risk aversion in lending, and limited new bankable projects.

13. Overall lending conditions remain tight. Credit growth has been sluggish despite declining lending rates. As corporate sector balance sheet repair has been modest, existing vulnerabilities cast doubt on prospects for a speedy credit recovery. High NPL levels are an indication of significant rigidities in the NPL resolution framework, reducing banks' willingness to lend; they have, in general, tightened credit risk management after the collapse of the lending boom. Weak credit demand appears to be another important factor.

14. A number of domestically owned banks face notable challenges. As a group, they have weaker profitabilty and higher operating[5] and funding costs than foreign-owned banks. Intensified competition for a limited number of good-quality borrowers will place additional pressures on interest rate spreads and banks' earnings. Also, the scope for business models that rely on servicing the government and government-owned companies is diminishing as the government is moving to more transparent business practices.

15. The viability of weaker banks should be carefully assessed and—if warranted—CBM should take decisive action. While the authorities have imposed higher capital requirements on one bank, weak banks should be subject to more intensive supervision and not be allowed to expand by collecting costly deposits. CBM should adopt bank-specific time-bound supervisory action plans, including requiring banks' owners to inject capital to cover the actual and anticipated losses. In the absence of timely compliance, banks should be resolved on a least cost basis. Delays in enforcement action may distort the banking market and increase the resolution costs significantly.

[5] For instance, at end 2014, aggregate ROA was 0.8 percent broken down by about zero for domestically-owned banks and about 1.1 percent for foreign-owned banks; the overhead costs-to-core income ratio (net interest and fees) was about 75 percent for the banking sector, with over 90 percent for domestically-owned banks and about 70 percent for others.

16. Indications of inadequate provisioning in some banks and an overall reliance on real estate collateral call for AQRs. External auditors have issued qualified opinions related to inadequate provisioning for a number of banks in 2013 and 2014. Furthermore, the mission found that in some banks the amount of loans past due by more than 90 days disproportionately exceeds the amount of nonperforming loans, as classified by CBM.[6] The supervisors also lack proper tools to challenge real estate collateral valuations of the banks. An independent AQR of banks is therefore urgently needed to estimate the extent of inadequate provisioning and inform subsequent supervisory action.

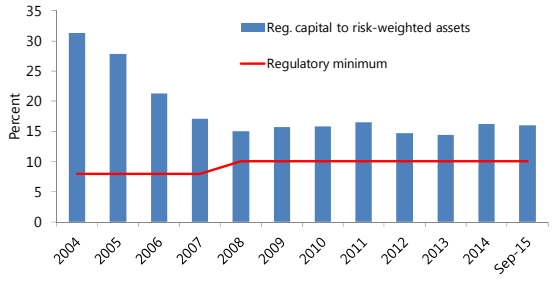
17. The insurance sector returned to profitability in 2011, although some insurers still suffer operating losses. While the CAR stood at 735 percent for life and 170 percent for non-life insurers at end-2014, the solvency margins were calculated on a Solvency I type of fixed factors, without taking into account the risk profiles of the assets or liabilities, underestimating risks and overstating capital.

18. The banking sector's high cross-border interbank exposures reflect the ownership structure, investment and hedging strategies, and search for alternative investment opportunities. While domestic interconnectedness between banks is low, banks' foreign claims and liabilities account for over 115 percent and 50 percent of total regulatory capital, respectively, as of end-2014. Exposures to foreign banks are mainly in the form of claims. Without viable and safe alternatives within the country, Montenegrin banks invest in foreign government securities and deposit part of their excess liquidity in EU banks. Some banks have also invested in higher yield sovereign bonds in the region, although these exposures are limited.

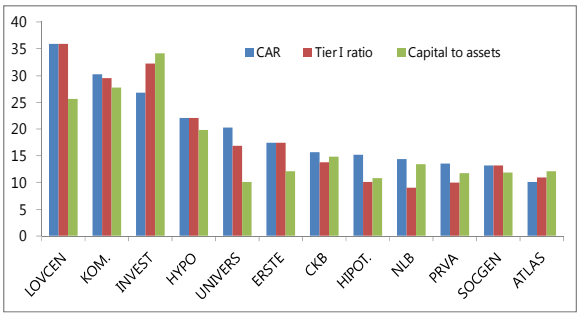
[6] Both banks received qualified audits in 2014.

Figure 2: Montenegro: Main Banking Sector Indicators

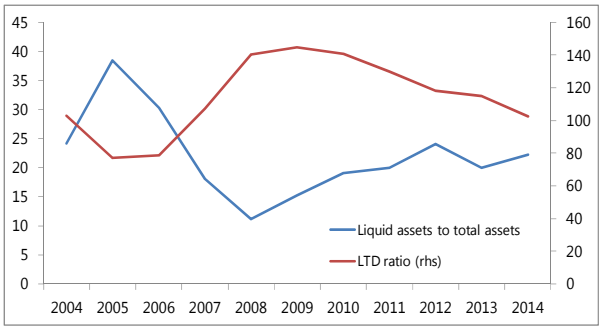
Bank capitalization has been stable



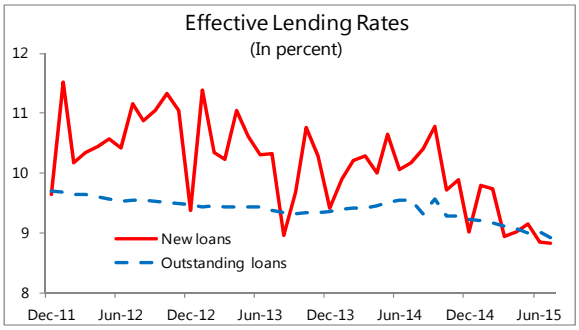
Tier I capital ratio is about 14% but with wide differences



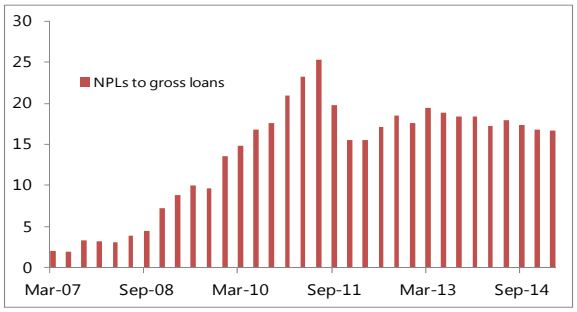
Liquidity and funding profile less risky



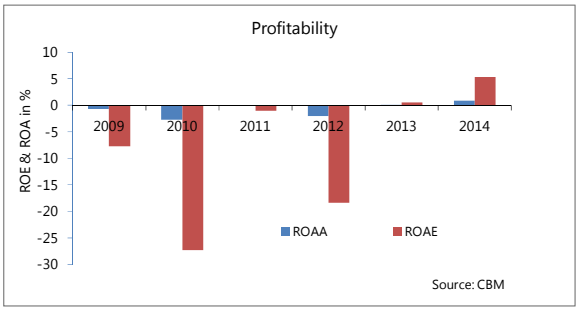
Overall lending conditions remain tight



NPLs have remained persistently high



Profitability is very low



19. Nonresident deposits are an important source of funding for some banks, being a relatively stable source over the past five years. On average, about 20 percent of deposits in the banking system belong to nonresidents, the majority denominated in euros. The share of nonresident deposits is below 20 percent in most banks, with only a few banks having higher shares. Over a quarter of nonresident deposits are from Russia.

B. Structural and Medium-Term Challenges

20. Weak credit growth is a concern for the authorities. In their view, weak credit growth is attributed to banks' overly-high risk aversion and to insufficient competition in the banking sector—consequently, the resulting high lending rates could have a negative impact on credit demand and hamper economic growth. Attempting to redress this situation, CBM has looked favorably at applications for new bank licenses. The authorities are also considering imposing lending rate caps to spur credit.

21. Competition in the banking sector is intense, evidenced partly by persistent weak profitability. Indicators suggest bank high interest rate spreads are driven by costs. Furthermore, competition has compressed spreads on new lending to levels threatening the survival of some smaller banks with higher funding and operating costs and a weaker client base. Anecdotal evidence suggests that cost pressures on the funding side, coupled with declining lending rates in the fight for a few good clients, have driven some banks into a high-danger zone.

22. The interest rate spread decomposition for the 2007–14 period shows that spreads on outstanding loans are driven predominantly by overheads and provisions while profit margins are mostly negative. In terms of concentration and market power, there seems to be no evidence of dominance in the market. The Herfindahl–Hirschman Index (HHI) was about 0.12 for each asset, deposit, and loan by end-2014, indicative of no market concentration. The index also shows a reduction in concentration in the period 2010–14.

23. The authorities were discouraged to introduce caps to lending rates and spur competition by issuing licenses. Introducing caps may further restrict credit to small- and medium-size enterprises and consumers as well as lead to an undesirable mispricing of risks. International experience with interest rate caps suggests they have a limited effect on reducing interest rates while having a negative impact on financial access.[7] The increase of the number of banks, particularly without strong business plans and solid capital, may lead to costly disruptions on the banking market.

[7] Maimbo, S. and Henriquez Gallego, C.A. "Interest Rate Caps around the World - Still Popular, but a Blunt Instrument," World Bank Group, October 2014.

24. There is no single and easy solution to address high lending rates that are relatively common in the region. In particular, a high cost of long-term funding, which is reflected in high sovereign yields, sluggish economy, overall high indebtedness and associated high credit risks, as well as low rate of recovery on NPLs and other structural rigidities in the economy are all likely to contribute to elevated lending rates and higher risk aversion.

III. FINANCIAL OVERSIGHT

A. Macro Prudential Perspective

25. While responsibilities for financial stability have been assigned, macro prudential policies or instruments are missing. The CBM has a financial stability objective, but lacks the toolkit for mitigating systemic imbalances. The FSC aims to monitor, identify, prevent, and mitigate systemic risks in the financial system but the FSC Law does not provide for a macro prudential toolkit or enabling clause to authorizing CBM to introduce macro prudential tools.

26. Within the current institutional framework, the macro prudential mandate should be vested in the CBM. This mandate should build on the existing regulatory and supervisory powers of the CBM, expanding them towards a macro prudential framework, and include powers over macro prudential instruments as part of the ability to act. The identification of instruments (such as loan-to- value, debt-service-to-income, and debt-to-income ratios, capital buffers) is particularly relevant, even without the need of immediate activation. The FSC, in turn, should retain its mandate over financial stability expanded with additional powers to issue recommendations on macro prudential policy. To ensure accountability and the willingness to act, these recommendations should be made public. The CBM should continue to chair and perform technical operations for the committee.

27. In preparation for Basel III, the priority should be to ensure sound liquidity risk management standards. This should be complemented with regulatory liquidity ratios to strengthen banks' short term resilience. The design of regulatory liquidity ratios suffers from several constraints, including: the bond market is shallow and illiquid; high-quality liquid assets (HQLA) are limited; and it is difficult to assess stressed outflows due to limited data series. This puts a bigger onus on the regulator to ensure that the liquidity ratios are dynamic and reflect developments both on the asset and liability sides of liquidity and rely on frequent calibration and

quantitative impact studies. CBM should strengthen liquidity risk supervision by focusing on significant currencies, dynamic and structural maturity mismatches, and feasibility of contingency plans for domestically-owned banks.

28. The CBM could take this opportunity to remove treasury bills from the list of eligible securities to meet RRs. By allowing banks to include treasury bills to fulfill up to 35 percent of reserve requirements may restrict the effectiveness of RR as a liquidity buffer given that the market for government securities is illiquid.

B. Banking Oversight

29. Laws and regulations governing banking supervision have improved significantly since the 2006 FSAP to align closer with Basel and EU requirements. CBM adopts a risk-based approach to banking supervision. While the approach is conservative in some elements, several important areas for improvement are identified, as presented below.

30. A more conservative approach by CBM to evaluation of business plans and issuance of new licenses is warranted. Three new banks were established since 2014. Each bank submitted detailed three-year business plans that, prima facie, appeared feasible. Nonetheless, in the current business climate, questions must arise about some banks' viability to survive.

31. While legislation provides for consolidated supervision, the concept is defined narrowly and application is limited. The supervisors focus on understanding and assessing group-wide risks, including reputational and contagion risks, but the definition focuses on the accounting and reporting aspect, and prudential ratios are not calculated on a consolidated basis.

32. Weaknesses in the broader operating environment are diluting effectiveness of credit risk management and CBM's ability to supervise this risk. These weaknesses include the unavailability and reliability of borrowers' audited financial statements, and inability to independently verify or establish connectedness among counterparties. There is also scope for excluding or discounting certain exposures while measuring credit risk, difficulty in quality evaluation and timely disposal of collateral, and third-party initiated modifications to bank-borrower contracts that adversely impact credit discipline.

33. The prudential framework for identification and measurement of problem assets is conservative in some respects, but has significant gaps that result in inaccurate presentation of the level and quality of nonperforming assets. This arises mainly because the prudential framework allows banks to re-classify assets on the basis of types of collateral held by them irrespective of the borrowers' ability to repay, and lacks adequate clarity and consistency for restructuring or rescheduling loans and their prudential treatment.

34. The implementation of CBM's prudential limits for related party transactions and large exposures is weak. CBM's measurement of exposures is at variance from Basel norms and diverts banks' and supervisors' attention from the gross exposures which reflect the maximum exposure to loss. The aggregate limit for all related party exposures is too high at 200 percent of own funds, compared to level of 25 percent under the BCP. There are also significant gaps in the definitions of 'related party' and 'related party transactions.' CBM should also expand the scope of supervision to address concentration risks, including sector concentration and concentration through collateral.

35. While the legal, regulatory, and supervisory frameworks for risk management are well established, there is scope for improvement. Banks should be required to improve the governance framework for risk management; and the CBM should address concentration of outsourcing activities at the system level to limited service providers, provide additional guidance to banks on monitoring and management of operational risk, concentration risk, funding risk, and interest rate risk in the banking book, and develop appropriate methodologies for supervising these risks.

36. While CBM has adopted a conservative approach to Basel II implementation by requiring higher minimum capital ratios and higher capital for operational risk and for country risk, gaps in measurement of capital and risk-weighted assets exist. The current framework (a) does not require banks to deduct deferred tax assets and significant investment in the equity of restructured borrowers, (b) allows fixed asset revaluation reserve at full value without being discounted, and (c) assigns a lower risk weight to nonperforming assets and exposures secured by commercial real estate.

C. Insurance Oversight

37. Insurance Supervision Agency (ISA) should transition from compliance-based supervision to risk-based supervision. While it has made substantial progress in developing the regulatory framework since its establishment in 2008, a risk-based supervisory framework needs to be adopted before implementing the Solvency II regime. At the minimum, ISA should introduce guidelines on corporate governance, and requirements on risk management and internal controls. Offsite supervision must include assessments of the risks of the insurer's business, the effectiveness of the insurer's risk management policy, and the adequacy of its capital.

38. ISA should develop a transition strategy to incrementally introduce Solvency II, currently envisaged by end-2018. To help the industry make this transition smoothly, ISA should develop a phased approach.

D. Financial Market Infrastructure Oversight

39. The legal and regulatory framework put in place since the 2006 FSAP is generally conducive for operations and further development of payment and settlement systems. The CBM Law provides CBM with sufficient powers to regulate and supervise payment systems, own and operate payment systems, participate in other payment systems, and license payment systems. The newly enacted Payment System Law aims to further harmonize the legal framework with EU laws.

40. At the core of the payment and settlement infrastructure is the CBM payment system which has both RTGS and DNS modules. This system is largely safe and efficient, but risk mitigation measures are required to minimize any residual liquidity risk and any consequential credit risk. These measures should include (i) amending the operating rules defining priorities for payment orders that could lead to their immediate rejection in the event of lack of balances; (ii) facilitating the automatic transfer of balances from the reserves account to the settlement account for settling any pending transactions; and (iii) automating the intraday liquidity facility on a collateralized basis. Partial unwinding of transactions (especially in the final settlement cycle) in the DNS system should be eliminated by amending the existing optional provision of reserving balances and making the same mandatory in the operating rules; and by exploring the feasibility of extending intraday liquidity facility to address any shortfall in balances for settling the net clearing file.

41. The CBM oversight function could be further strengthened with an oversight policy framework consistent with the Payment System Law and relevant international standards. The policy framework should outline the public policy objectives of oversight, CBM's oversight standards, the scope of the oversight, the oversight activities and tools, and the mechanisms for cooperation with other regulatory authorities.

E. Anti-Money Laundering and Combating the Financing of Terrorism

42. Montenegro is taking active steps to enhance its AML/CFT framework and reach a better understanding of its money laundering and terrorist financing risks (ML/TF). When it was last assessed, Montenegro's framework was found to suffer from significant deficiencies.[8] Some progress has since been made, in particular through the 2014 amendments of the AML/CFT law. The amendments notably strengthened customer due diligence (CDD) obligations by requiring reporting entities to verify the identity of a person purporting to act on behalf of a corporate customer, and by allowing the application of simplified CDD in instances of "insignificant" ML/TF risk and no suspicion of ML/TF. Practical steps were also taken to improve the reporting of suspicious transactions (e.g., the indicators of suspicious transactions were expanded, and training events were conducted for reporting entities).

43. Significant deficiencies nevertheless remain. The scope of the reporting requirements remains too narrow, as it refers to the reporting of "transactions" (rather than "funds") and of "suspicion of ML/TF" (rather than "suspicions of funds that are the proceeds of a criminal activity"). Information on the beneficial ownership of legal persons created in Montenegro does not appear to be accessible to competent authorities in a timely manner. While some information is collected by reporting entities, it does not appear adequate. Enhanced due diligence measures are insufficient, notably because reporting entities are not required to establish on a risk basis the source of wealth of beneficial owners identified as domestic PEPs. In addition, there are no provisions to prevent criminals or their associates from holding or being the beneficial owners of a significant or controlling interest or holding senior management functions in certain non-bank financial sector institutions.[9]

[8] Montenegro's AML/CFT framework was last assessed in 2008 and partially re-assessed against the previous standard (the FATF 2003 Recommendations) in 2014. Both assessments were conducted by MONEYVAL, the FATF-style regional body of which Montenegro is a member. The report of the 2014 assessment is available at http://www.coe.int/t/dghl/monitoring/moneyval/Evaluations/round4/MNE4_REP_(2015)12_en.pdf

[9] Investment management companies, pension fund management companies, or stock brokers.

IV. RESOLUTION OF NONPERFORMING LOANS

A. Nonperforming Loans

44. NPLs remain a difficult legacy reflecting the impact of the global financial crisis and subsequent economic slowdown as well as lax pre crisis lending standards. If not reduced, NPLs will continue to burden banks' balance sheets, undermine profits and capital, and suppress banks' appetite for new lending. As the bulk of NPLs are backed by real estate collateral, the state of the real estate market—in combination with some banks' inability and unwillingness to absorb losses—is a key impediment for reducing NPLs. The absence of sound estimates for the shortfall in provisions relative to actual losses that would be incurred in more rapid NPL resolution impedes effective policy formulation.

45. Recently strengthened supervisory requirements should be complemented by reversing the loosening of regulatory standards over the last several years. The CBM has introduced a requirement for banks to prepare a multi-year NPL resolution strategy, including annual operational targets and quarterly reporting against those targets. It is also essential that CBM also strengthens regulatory standards and enforcement to establish loss provisions that better reflect expected losses. Where appropriate, banks should be required to raise additional capital to support these provisions and to create headroom to absorb the losses that would be associated with future NPL workouts and write-offs. To ensure compliance with tightened regulatory standards, CBM should consider establishing a specialized team within the supervision department—but distinct from staff responsible for individual bank relationship management and for supervising the credit risk management function generally—that would serve as a resource to the relationship managers and their teams, support the supervision of NPL management practices in all banks.

46. In order to analyze, regulate, and monitor the NPL problem in its entirety, it is recommended to bring nonbank credit institutions and asset management vehicles under CBM oversight. In addition to the EUR 397 million NPLs on banks' books, around EUR 720 million has been sold, predominantly to parent banks and affiliated SPVs. Reporting these exposures to the credit registry should be made mandatory to comprehensively monitor NPL dynamics, which will likely require some form of CBM oversight of such institutions.

B. Insolvency and Creditor Rights

47. A number of legal and institutional reforms seeking to improve the framework for NPL enforcement have been undertaken in recent years but certain gaps remain. The legal framework governing bankruptcy is comprehensive and security rights are adequately protected in liquidation. Nonetheless, there remains substantial variability in the speed and quality of enforcing some legal provisions by the courts. A business rescue culture is not developed. Reorganization is not extensively used and most bankruptcy cases end up in liquidation. Out-of-court reorganization ('workouts') is not a common practice. Land titling and cadastral information has been improving but gaps remain, especially in rural areas.

48. The recently enacted Law on Voluntary Restructuring of Debts should be complemented with additional legal measures. In particular, eligibility for using the law should be broadened to loans which encompass debtors in serious financial distress or insolvency. Also, the out-of-court debt restructuring mechanism needs to be complemented by a fast track procedure to confirm workout plans previously approved by a legally defined majority of creditors, making such plans obligatory with respect to all creditors. This would encourage creditors to participate in out-of-court negotiations and limit threatening attitudes from minority creditors ('hold-outs').

49. The recent Law on Consumer Bankruptcy raises several concerns and should be amended or clarified through regulations. The current text does not contemplate adequate safeguards to protect the secured creditors' rights. For example, the law establishes, depending on interpretation, a radical exemption in favor of a bankrupt debtor's house, which cannot be sold in bankruptcy, provided that this is "commensurate with the basic housing needs of the consumer." The law implementation, however, is not expected immediately,[10] If the exemption would apply to loans secured with a mortgage created before the entering into force of the law, most of such loans would be considered unsecured and its collection perspective could be significantly reduced.

[10] The authorities should clarify through regulation that the law excludes the debtor's house from sale on insolvency where the house is not subject to a mortgage or other security right.

V. FINANCIAL SAFETY NET

A. Institutional Arrangements

50. While the establishment of the FSC and its activities should be welcomed, there is scope for improvement. In 2010 the FSC was established to maintain financial system stability and avoid financial distress. Several inter-agency Memorandum of Understandings (MOUs) have not been updated after establishment of the FSC; overlapping scopes with the FSC Law and the absence of MOUs between several institutions raise questions about the institutional framework. The DPF should be an FSC member; while the FSC Law permits to do so, the DPF has not been invited to any of the FSC meetings that have been held to date. The FSC members should have the formal authority to send representatives to the meetings as the functioning of the FSC in the current framework could be hampered in the case of the temporary absence of a member.

51. The CBM should be confirmed as the resolution authority for the institutions under its supervision. The CBM is the *de facto* resolution authority for banks. In light of the size of the country and its banking sector there is no need to establish a new resolution authority. To support its effectiveness, a dedicated full-time, small resolution unit within CBM should be established. The unit should have ready access to resources throughout CBM. Its reporting line to the CBM Board should be separate from the department responsible for emergency liquidity assistance and also from the Supervision Department.

52. While the agencies' contingency plans and the national contingency plan (NCP) should be welcomed, there is scope for improvement. FSC has adopted the NCP to complement institution-specific contingency plans. However, the FSC does not pay continued attention to its statutory crisis preparedness and management mandate; it focuses on its systemic risk monitoring mandate. Progress with the NCP's implementation is not regularly tabled for discussion by the FSC and it has yet to organize a system-wide crisis simulation exercise involving all FSC members and the DPF. Moreover, none of the oversight agencies have formal cross-border arrangements with home resolution authorities; nor is a cross-border crisis management framework in place.

B. Failure Mitigation Regime

Early intervention

53. CBM is authorized to impose a wide variety of early intervention measures on banks under a range of circumstances, including if in its assessment the bank's financial viability could be threatened. These measures include scaling down or ceasing certain operations, establishing adequate reserves for losses, selling assets, restricting or ceasing dividends, increasing capital, and removing executive directors or board members, among others.

Recovery Planning

54. CBM requires banks to undertake contingency planning, including for purposes of restoring capital and liquidity in times of stress. While full recovery plans as envisioned under the EU Bank Resolution and Recovery Directive (BRRD) and related European Banking Association (EBA) guidance are not yet required, banks are required to prepare contingency plans for managing their liquidity in crisis situations—CBM has issued detailed written guidance outlining its expectations. Banks' liquidity contingency plans are evaluated as part of individual bank supervision. Similarly, as part of its regular supervisory processes CBM requires banks to prepare capital plans that must be updated annually.

C. Failure Resolution Regime

Resolution powers

55. CBM can appoint an Interim Administrator who has the power to resolve a potentially failing bank. The Interim Administrator assumes the powers of the shareholders, the board, and the executive directors; and has wide powers, including to sell assets and to transfer assets and liabilities to another bank. CBM directs and supports the interim administration. The outcome is either resolution via recapitalization or the transfer of some or all assets and liabilities to another bank, or bankruptcy[11].

[11] Given the authorities' plans to transpose the BRRD in 2017, this section describes how CBM and MoF could strengthen the existing resolution framework in the interim period.

56. Certain desirable resolution powers are not available. These include the power to use DPF funds to finance the transfer of insured deposits through P&A, the power to establish a bridge bank, and—as a last resort—the power to recapitalize and temporarily fund a systemically important bank (including via use of a bridge bank) in the absence of a private sector-funded resolution. Although there is a possibility to amend legislation in the extraordinary circumstances, the lack of certainty as to whether these legal powers would actually be available when needed complicates resolution planning.

Resolution planning

57. CBM as the *de facto* resolution authority has yet to initiate bank-specific resolution planning. In line with global and regional good practice, CBM is recommended to start bank-specific resolution planning even before the formal transposition of BRRD is completed, including conducting resolvability assessments to determine impediments to the resolution of specific banks. This work should be executed by the resolution unit proposed above, be prioritized based on banks' CAMEL ratings, and be coordinated with home authorities—without being dependent on these authorities. Should structural impediments to resolvability be identified, CBM should consider using its powers under the Banking Law to cause the bank to remedy those impediments.

Resolution funding

58. Existing resolution funding powers and arrangements are limited and should be strengthened. While the draft legislation which is expected to be adopted in the extraordinary circumstances would provide some useful tools to support the effective resolution of a systemically important bank (e.g., ability to establish a bridge bank), its liquidity and capital support provisions and related safeguards should be strengthened. The Deposit Protection Law (DPL) should be amended to enable DPF to finance transfer of insured deposits to another bank through purchase and assumption transactions (P&A).[12] In case of systemic crisis, the emergency legislation should authorize the MOF to borrow and/or use budgetary means up to a specified limit without requiring ex ante parliamentary approval for each case, though with ex post parliamentary accountability.[13] The MOF could establish a fee-paid (committed) contingent credit line with a reputable foreign bank or an international financial institution.

59. The rules for the use for th*e public funding* in crisis situation should be clearly defined. Shareholders and hybrid capital and subordinated debt holders should fully absorb losses and shareholders should be fully written off prior to any government capital support. The objective to follow a least cost resolution method should be explicitly introduced in the law. To guide the potential provision of such support, CBM and MOF should adopt explicit policies that set strict, objective, quantifiable, and measurable criteria for determining whether a bank is so systemically important that its failure would have severe repercussions for the financial system or the economy. The provision of public funds should be contingent on formulation of a restructuring plan that ensures long-term viability.

[12] The amount of its assistance should be restricted to the costs DPF would otherwise have incurred in a pay-out of insured deposits in liquidation, net of recoveries. DPF should sign an MOU with the MOF to address the issues of back-up finance from the budget as foreseen in the DPL and guarantees from MOF for DPF borrowing, in both cases to cover any shortfall of the fund.

[13] MOF has the possibility to establish contingent lines of credit with two local banks but does not have them in place and, in any case, these could be unavailable in a crisis.

D. Deposit Insurance

60. The deposit insurance framework is relatively well developed but has never been triggered. DPF operates under the narrow mandate of a pay-box. It is financed by annual premiums from member banks, supported by a standby credit line with the EBRD and a statutory provision for back-up funding from the government. The current level of funding is sufficient to cover all insured deposits in all small banks. The coverage level is EUR 50,000 per depositor per bank and covers natural and legal persons. Since its establishment, DPF has developed much of the infrastructure required to ensure prompt pay-out of deposits, including pay-out software to reimburse depositors within fifteen working days after a bank failure and an MOU to support information exchange and coordination with CBM.

61. To further enhance the effectiveness of the deposit insurance system, the DPL should be amended to enable DPF to finance the transfer of insured deposits to another bank. In addition, DPF should be allowed to use other options for pay-out, including the ability to make payments electronically to deposit accounts established by depositors in other banks or to use interim or advanced payments in the case of prolonged delays. Furthermore, when transposing EU directives the pay-out timeframe should be further shortened to seven working days and risk-based premiums should be introduced.

E. Liquidity Support

62. Limited resources to finance ELA constrain CBM's LOLR ability. Due to its inability to create money, CBM would need to provide financial assistance from its capital. A formalized emergency liquidity support framework is in place under the CBM Law, with additional provisions laid out in the draft legislation expected to be adopted in extraordinary circumstances. The single framework should be established, to include only those components of the existing legislation that reflect best international practices**.**

63. To avoid delays in providing ELA and to limit its risk exposure, CBM should have available—for internal use—a list of acceptable collateral with pricing and haircut methodologies. While it is difficult to prepare for all possible scenarios and types of collateral, CBM should develop a list of what would constitute 'other collateral deemed acceptable' along with pricing and haircut methodologies, as well as develop its capacity to administer such assets. To safeguard CBM's financial autonomy, alternative sources of funds and additional conditions and restrictions for CBM ELA should be considered.

64. Banks requesting access to CBM ELA must first exhaust all existent sources of liquidity. Further safeguards could include (i) requiring an objective, pre-determined solvency test both at the start and duration of ELA; (ii) capping the use of CBM's fund for ELA and implementing measures to reimburse CBM for its ELA-related losses; (iii) requiring foreign-owned banks' parents to provide a letter of comfort to provide liquidity in times of stress; (iv) prescribing appropriate safeguards for the use of ELA by the receiving bank and enhancing monitoring to minimize moral hazard, (v) and allowing banks to draw down the required reserves at CBM below the minimum requirement for a short period.

VI. FINANCIAL SECTOR DEVELOPMENT AGENDA

A. Financial Inclusion for Individuals and SMEs

Access to Finance for Individuals

65. The growth of the financial sector since the 2006 FSAP has contributed to greater access to finance, but also exposed vulnerabilities and risks. The share of adults with a deposit or savings account has risen steadily over the past years, but remains below income group and neighboring countries. The savings rate is significantly below ratios found in comparable economies, as well as the share of adults using a financial institution for this purpose. In contrast, the share of the population that has borrowed money is high, with a relatively high share of individuals borrowing from entities not subject to effective oversight. Rising levels of household indebtedness raise questions on their debt service capacity and stress the importance of robust monitoring and consumer protection arrangements (Table 2).

66. The authorities should consider comprehensive revision of the legal and supervisory framework to ensure that all entities providing credit are subject to the CBM's oversight. The legal and regulatory framework should be reviewed to create a level playing field between providers of equivalent financial services and be commensurate to the risks their activities pose to the financial health of financial service providers and consumers. While the team welcomes the planned legal changes to subject factoring and leasing companies to CBCG oversight, the possible solution for stores and other non-financial firms which issue credit could be to require them conduct such transactions through a licensed financial institution.

Table 2. Montenegro: Financial Inclusion for Individuals

	Montenegro 2011	Montenegro 2014	Western Balkans	Upper middle income	Europe & Central Asia (developing only)	Euro area
1. Account ownership			**(% age 15+)**			
Account at a financial institution	50.4	59.8	67.1	70.4	51.4	94.8
2. Savings						
Saved any money in the past year	N.A.	26.8	38.9	62.7	38.5	67.2
Saved at a financial institution	3.4	5.3	13.9	32.2	8.4	47.6
3. Borrowing			**(% age 15+)**			
Borrowed any money in the past year	N.A.	50.1	41.9	37.7	39.5	35.4
Borrowed from a financial institution	21.8	23.5	14.4	10.4	12.4	15.8
Borrowed from family or friends	35.3	20.7	21.2	24.0	23.6	14.5
Borrowed from a store by buying on credit	N.A.	21.7	15.8	5.0	10.0	10.6
Outstanding mortgage	N.A.	21.7	15.8	5.0	10.0	10.6
4. Availability and Usage of Payment Instruments			**(% with and account, age 15+)**			
Credit card	13.9	15.3	19.2	16.8	18.5	41.9
Debit card	22.0	33.8	49.6	45.9	36.9	81.1
Main mode of withdrawal: ATM	35.9	33.2	50.4	55.7	66.7	N.A.
Main mode of withdrawal: bank teller	N.A.	59.4	41.3	39.1	21.8	N.A.

Source: CBM, MEF

67. Concerns about over excessive interest rates and harmful market practices would be best addressed by improvements in market conduct regulation and oversight, and consumer protection. The regulators should ensure that all credit providers are subject to identical disclosure and market conduct rules, and harmful practices should be sanctioned irrespective of the source of financing. While CBM has already introduced measures to increase disclosure and transparency, including standardized interest rate calculation methodologies and disclosure sheets with loan conditions and terms, there is scope for improving monitoring and enforcement.

Access to Finance to SMEs

68. Similar to other post-crisis Western Balkan economies, Montenegro's SMEs continue to have limited access to credit, which is associated with high cost and stringent conditions. A recent World Bank survey suggests that more than 40 percent of formal SMEs do not have a bank loan or line of credit, and those who do, need to provide on average collateral equivalent to more than 200 percent of the loan amount.[14]

69. Addressing the SME finance challenges requires a comprehensive approach

[14]World Bank Enterprise Survey, 2013.

addressing weaknesses in the enabling environment and strengthening the capacity of firms and financial service providers. The improvements in credit reporting and financial reporting (see sections below) would help reduce information asymmetries. Financial institutions should be encouraged to develop delivery models tailored to the characteristics of SMEs. Finally, public support instruments could be improved to ensure the effectiveness and efficiency of their interventions.

70. The Investment and Development Fund (IDF) has the potential to support greater access to finance for SMEs. To increase its effectiveness and minimize market distortions, IDF should increase the share of SME-focused programs through commercial banks and gradually remove the formal caps on interest rates. Corporate governance and the monitoring/evaluation framework should be improved in line with international good practice, IDF needs to be subject to CBM oversight, and its operations should be reflected transparently in government fiscal accounts.

B. Financial Infrastructure

71. While the modernized framework for payment systems is conducive for further development of retail payment services, the usage of electronic transactions remains low. The newly enacted Payment System Law largely harmonizes the legal framework with EU norms and enables CBM to license payment service providers. The retail payment infrastructure includes a network of interoperable ATMs and PoS terminals. Few ATMs are equipped with multi functionality features such as utility bill payments and mobile top-ups. A possible factor contributing to the relatively low usage of credit and debit cards may be higher fees associated with the settlement of card transactions through international networks**.**

72. Coordinated efforts by the authorities and market participants are needed to increase the use of electronic transactions. This could be achieved through establishment of a National Payments Council (NPC), which should be led by CBM and comprise all relevant stakeholders, including regulators,[15] MOF, and payment service providers. NPC would adopt a suitable strategy with time bound implementation plan. Illustratively, this strategy could focus on measures (i) to facilitate transaction accounts for all citizens, greater usage of (debit and credit) card, and interoperability of e-money products; (ii) to promote online payments through the internet and mobile with adequate security measures; (iii) to deepen the PoS infrastructure; (iv) to rationalize the fee structure; and (v) to leverage the existing payment infrastructure to promote retail electronic payment products.

73. CBM should promote the channeling of remittance proceeds into payment accounts. Currently, all remittances (EUR 39 million in 2014) are paid out to beneficiaries in cash by the remittance service provider. Directing this significant inflow to the banking system would have a positive impact on savings and economic growth.

[15] Securities and Exchange Commission and Montenegro Agency for Electronic Communications and Postal services.

74. While CBM is already running a well-functioning credit registry (CR), further improvements could be made to expand coverage, granularity, and timeliness of available credit information. Priority should be given to subject all providers of credit to CR, which would include loans given by stores/supplies as well as leasing and factoring companies. Additional improvements could target the granularity of financial information that is distributed, including more detailed information on the credit history and payment behavior of borrowers, and better identification and coverage of nonresidents in coordination with relevant home authorities. These reforms would further enhance the quality of credit information, which would greatly contribute to better risk management and financial inclusion.

C. Corporate Financial Reporting

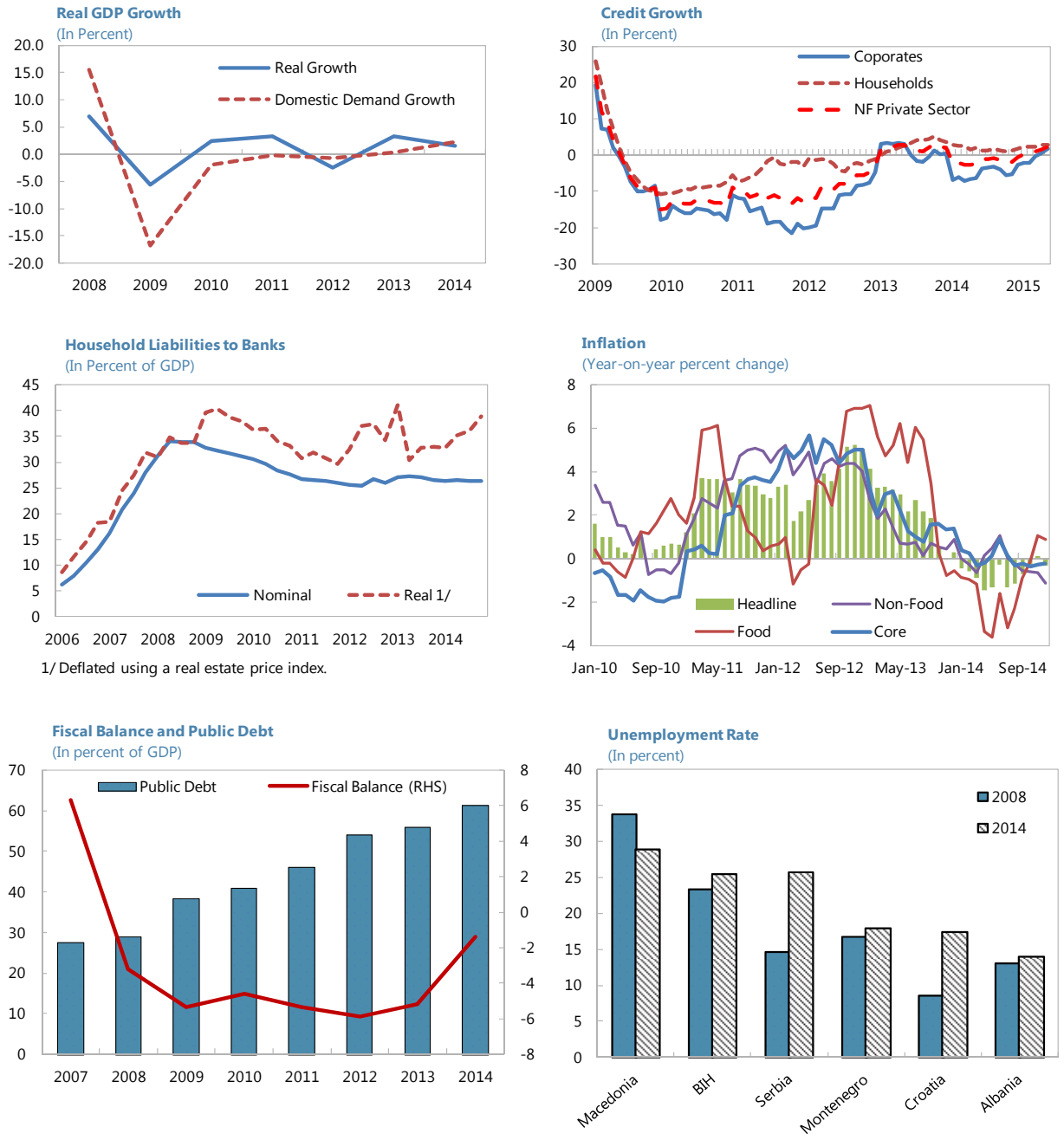
75. Montenegro has undertaken important efforts to improve the corporate financial reporting framework since the 2006 FSAP, but further challenges remain pertaining to the application and enforcement of financial reporting. Notable progress was made in strengthening core accounting and auditing standards (including IFRS, ISA, and the Code of Ethics), publication requirements, and development of the accounting and auditing profession. Financial regulators have sufficient powers to enforce financial reporting and auditing standards for financial institutions. However, there is no legal definition of Public Interest Entity (PIEs), and there is no public oversight system (POS) or a mandatory system of quality assurance review (QAR) over the external audit function. Requirements to file financial statements and audit reports and make them public are in place, but in practice many companies fail to timely adhere to their filing obligations and published information is not complete. The application of full IFRS requirements for all legal entities presents a particular challenge to SMEs, which are often unable to apply the accounting standards adequately. Capacity constraints on all levels of the financial reporting chain have a negative impact on the quality of corporate financial information, which increases the cost and availability of financing**.**

76. Improving the quality of financial reporting requires further improvements in the legal framework and institutional capacity. The ongoing modernization of the legal framework should include: (i) a formal legal definition of public interest entities; and (ii) provisions for a public oversight system and a mandatory system of quality assurance review over the statutory audit function. Given the capacity constraints both in the SME sector and the audit profession, the authorities should consider introducing simplified financial reporting standards for smaller entities such as the "IFRS for SMEs,"[16] which would alleviate the workload of SMEs and audit professionals while still maintaining sound financial reporting standards. Finally, the tax authorities should be equipped with adequate resources and tools to effectively oversee and enforce the timely publication of financial statements and quality controls to promote the completeness and accuracy of reported financial information.

[16] The IFRS for SMEs are issued by the IASB and are a self-contained standard designed to meet the reporting needs of smaller companies.

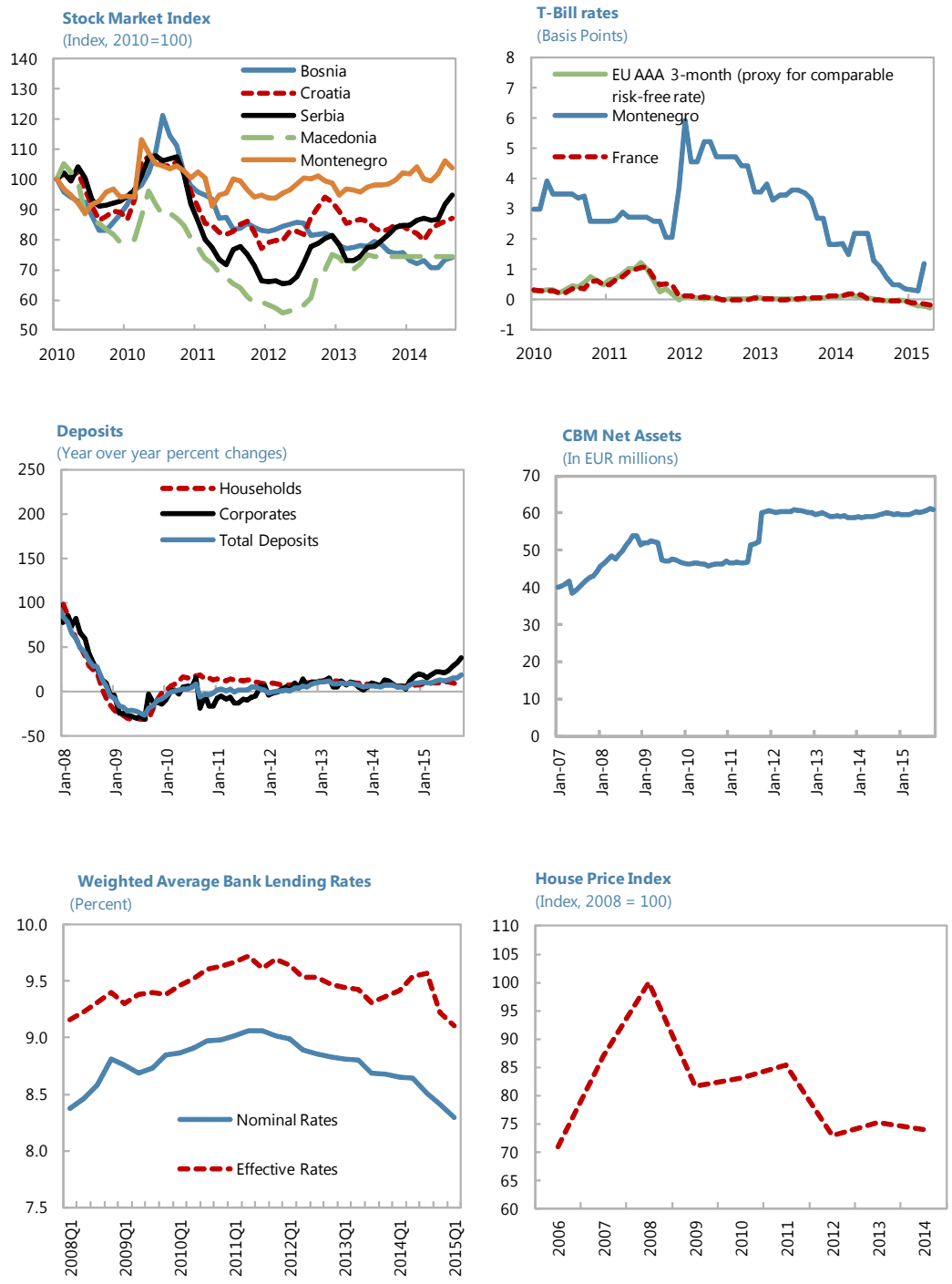
Appendix I. Figures and Tables

Appendix Figure 1. Montenegro: Selected Economic Indicators



Sources: Montenegro Authorities; and IMF staff estimates.

Appendix Figure 2: Montenegro: Monetary and Capital Market Developments



Appendix Figure 3. Montenegro: Key Financial Soundness Indicators: Cross-Country Comparisons

Source: IMF Financial Soundness Indicators Database; Bank of Albania; and National Bank of Serbia.
1/ The red bars represent data for 2014Q3 .
2/ The red bars represent data for November 2014.

Appendix Table 1. Montenegro: Selected Economic Indicators, 2010–2015

(Under current policies)

	2010	2011	2012	2013	2014	2015 Proj.
Real economy						
Nominal GDP (millions of €)	3,104	3,234	3,149	3,327	3,425	3,586
Gross national saving (percent of GDP)	-2.6	-2.0	0.9	4.3	3.2	8.1
Gross investment (percent of GDP)	22.8	19.5	19.5	18.9	18.5	25.8
			(percent change)			
Real GDP	2.5	3.2	-2.5	3.3	1.5	3.2
Industrial production	17.5	-10.3	-7.1	10.6	...	...
Tourism						
Arrivals	4.6	8.7	4.8	3.7	...	...
Nights	5.5	10.2	4.3	2.8	...	...
Consumer prices (period average)	0.7	3.1	3.6	2.2	-0.7	1.7
Consumer prices (end of period)	0.7	2.8	5.1	0.3	-0.3	1.8
GDP deflator (percent change)	1.6	0.9	-0.1	2.2	1.4	1.4
Average net wage (12-month) 1/	3.5	1.0	0.6	-1.6	...	...
Money and credit (end of period)						
Bank credit to private sector 2/	-8.9	-13.0	-3.1	2.1	-0.4	0.5
Enterprises	-11.2	-20.3	-4.9	0.1	...	...
Households	-5.7	-3.2	-1.1	3.7	...	...
Private sector deposits	5.9	1.2	7.2	5.4	...	...
General government finances 3/			(as percent of GDP)			
Revenue and grants	41.3	37.8	40.0	41.6	44.0	42.1
Expenditure	45.9	43.1	45.9	46.7	45.3	52.1
Overall balance	-4.6	-5.3	-5.9	-5.2	-1.3	-10.0
Primary balance	-3.6	-3.9	-4.0	-3.0	0.9	-7.2
Domestic financing (net)	-1.4	0.7	-0.8	-0.4	-1.7	-1.5
Privatization receipts	0.8	0.5	0.4	0.8	0.3	0.3
General government gross debt	40.9	46.0	54.0	55.8	60.5	69.9
General government debt, including loan guarantees	52.4	57.8	65.0	65.2	69.9	79.3
Balance of payments						
Current account balance	-22.9	-17.7	-18.7	-14.6	-15.4	-17.7
Foreign direct investment	17.8	12.0	14.7	9.7	10.3	11.4
External debt (end of period, stock)	142.6	146.4	157.5	153.1	164.4	174.5
Of which: Private sector 4/	113.2	113.5	116.4	112.4	118.8	119.7
REER (CPI-based; annual average change, in percent)						
(- indicates depreciation)	2.8	-3.2	3.3	-1.1	...	...
Memorandum:						
Nominal GDP Growth (in percent)	4.1	4.2	-2.6	5.7	2.9	4.7
Aluminum price (€ per tonne)	1,644	1,822	1,542	1,348	1,514	1,568

Sources: Ministry of Finance, Central Bank of Montenegro, Statistical Office of Montenegro, and IMF staff estimates and projections.

1/ Reflects a change in the methodology by Monstat starting January 1, 2010.

2/ A change in classification in off-balance sheet items has resulted in a structural break in 2012; the annual changes for credit growth in 2013 are distorted by the change in methodology.

3/ Includes extra-budgetary funds and local governments, but not public enterprises.

4/ Estimates, as private debt statistics are not officially published.

Appendix Table 2. Montenegro: Financial System Structure, 2005–2014

	2007	2008	2009	2010	2011	2012	2013	2014	2015 1/
Number of Institutions									
Banks	11	11	11	11	11	11	11	12	14
Domestic-majority owned	3	2	2	2	2	2	2	5	5
Domestic private banks	3	2	2	2	2	2	2	5	5
Domestic state-owned banks	-	-	-	-	-	-	-	-	-
Foreign-majority owned	8	9	9	9	9	9	9	7	7
Subsidiaries of foreign banks	6	6	6	6	6	6	6	6	6
Branches of foreign banks	-	-	-	-	-	-	-	-	-
Insurance companies								11	
Life								6	
Non-life								5	
Leasing companies	4	4	4	4	5	5	5	5	5
Investment funds (asset management companies)								5	
Open-ended funds								5	
Closed-end funds								5	
Investment intermediaries								10	
Microcredit organizations	5	5	5	5	6	6	6	5	5
Stock exchanges								1	
Central depository agency								1	
Voluntary pension fund management companies								2	
Voluntary pension funds								2	
Financial system assets (in millions of euro)									
Banks	2,975.4	3,309.7	3,025.2	2,943.7	2,809.7	2,808.3	2,959.2	3,136.3	3,138.6
Domestic-majority owned	634.2	510.7	391.5	341.4	289.4	280.0	288.9	642.7	653.0
Domestic private banks	634.2	510.7	391.5	341.4	289.4	280.0	288.9	642.7	653.0
Domestic state-owned banks	-	-	-	-	-	-	-	-	-
Foreign-majority owned	2,341.3	2,799.0	2,633.8	2,602.3	2,520.3	2,528.3	2,670.3	2,493.6	2,485.6
Subsidiaries of foreign banks	2,265.8	2,552.9	2,357.1	2,271.7	2,162.5	2,126.5	2,179.5	2,200.9	2,164.2
Branches of foreign banks	-	-	-	-	-		-	-	-
5 largest banks	2,488.6	2,797.1	2,470.6	2,262.7	2,073.2	2,029.9	2,082.2	2,139.1	2,132.1
Insurance companies								168.9	
Life								54.6	
Non-life								114.3	
Leasing companies	167.9	246.5	252.1	203.3	170.6	143.4	117.9	75.6	72.9
Investment funds (asset management companies)								19.2	
Open-ended funds								30.5	
Closed-end funds								105.2	
Investment intermediaries								2.4	
Microcredit organizations	54.4	79.1	75.4	58.7	44.4	36.2	34.6	38.3	41.0
Stock exchanges								2.0	2.0
Central depository agency								0.9	
Voluntary pension fund management companies								0.6	
Voluntary pension funds								0.5	
Total assets								3,580.4	

1/ Latest available.

Appendix Table 3. Montenegro: Financial Soundness Indicators

(In percent)

	2009	2010	2011	2012	2013	2014	Jun-15
Capital Adequacy							
Total capital to risk-weighted assets	15.8	15.9	16.5	14.7	14.4	16.2	15.8
Tier I capital to risk-weighted assets	15.5	15.5	15.1	15.8	13.0	14.4	-
Total capital to total assets	11.0	10.6	10.9	10.3	13.4	14.2	14.1
Asset Quality							
NPL to total loans	13.5	21.0	15.5	17.6	18.4	16.8	16.4
Provisions to NPL	46.3	30.7	32.8	40.2	48.2	49.5	44.4
NPL net of provisions to Tier I capital	59.5	115.8	71.8	77.1	101.9	77.9	-
NPL net of provisions to capital	52.5	102.8	66.9	68.0	62.4	49.3	48.5
Top-ten borrowers to Tier I capital	97.9	130.0	116.2	227.5	180.6	156.3	-
10-largest credit to net credits	15.5	17.1	18.0	17.3	21.9	21.7	-
Earnings and Profitability							
Return on assets	-0.6	-2.7	-0.1	-2.0	0.1	0.8	0.5
Return on equity	-6.9	-27.0	-0.6	-18.0	0.9	5.7	3.7
Net Interest Margin	4.9	4.9	4.8	5.0	4.2	4.7	2.1
Non-interest expenses to gross income	67.1	93.0	73.6	90.3	69.9	65.9	72.7
Liquidity ratios							
Liquid assets to total assets	15.3	19.1	19.9	24.0	20.0	22.2	20.5
Liquid assets to short-term liabilities	25.8	32.9	32.8	40.1	32.2	35.7	32.1
Foreign currency loans to total loans	4.0	4.1	2.3	1.9	3.9	3.9	-
Foreign currency liabilities to total liabilities	6.4	6.9	4.9	4.8	4.3	4.7	-
Sensitivity to Market Risk							
Net long position in foreign exchange to Tier I capital	0.7	0.8	1.0	-0.8	0.6	0.7	-

Source: CBM

Appendix Table 4. Montenegro: Banking System Assets, End-March, 2015

	Assets	
	EUR million	% total
Atlas banka AD Podgorica	248.9	7.9
Crnogorska komercijalna banka AD Podgorica	559.8	17.8
ERSTE Bank AD Podgorica	361.5	11.5
Hipotekarna banka AD Podgorica	321.5	10.2
Hypo Alpe-Adria Bank AD Podgorica	237.8	7.6
Invest banka Montenegro AD Podgorica	44.1	1.4
Komercijalna banka AD Budva	115.7	3.7
Lovcen banka AD Podgorica	27.4	0.9
NLB Montenegrobanka AD Podgorica	502.7	16.0
Prva banka Crne Gore AD Podgorica	268.0	8.5
Societe Generale banka Montenegro AD	386.7	12.3
Universal Capital Bank AD Podgorica	64.7	2.1
Zapad banka AD Podgorica 1/	n.a.	n.a.
ZIRAAT Bank Montenegro AD Podgorica 2/	n.a.	n.a.
Total	3,138.6	100.0
Memo items:		
Assets Domestic-Majority Owned Banks	653.0	20.8
o/w Public Participation	312.1	9.9
Assets Banks w/ Public Participation	1,522.9	48.5
Assets Foreign-Majority Owned Banks	2,485.6	79.2

1/ Licensed on January 30, 2015.
2/ Licensed on April 6, 2015.

Appendix II. Progress on 2006 FSAP Recommendations

2006 Main Recommendations	2015 Status Update
Managing Growing Credit Risk	
Study and evaluate banks' risk management systems and practices, with a view to identifying best practices and weaknesses.	**Partially implemented**. As a part of the supervision system, the supervisors perform periodical evaluations of banks' credit risk management system and practices. The supervisory finding are yet to be utilized for disseminating best practices
Tailor remedial actions on a bank-by-bank basis.	**Implemented**. The measures against banks are determined depending on the specifics and the risk profile of each individual bank.
Periodically review the prudential framework to determine potential weaknesses and identify appropriate responses, including bank-specific supplementary capital adequacy levels, provisioning requirements and assets' risk weights.	**Partially implemented**. A periodical review of the prudential framework is performed, and the determined weaknesses were corrected through the amendments to the regulation, especially through the adoption of the new Decision on Capital Adequacy of banks (2010) and the Decision on Minimum Standards for Credit Risk Management at the Banks. CBCG is yet to establish bank-specific prudential requirements, other than for minimum capital adequacy.
Public Role in Financial Sector	
Public sector to operate at an arms-length basis with financial institutions to improve governance and risk management.	**Partially implemented**. Some banks still have a large share of deposits from state-owned enterprises.
Liquidity Management Framework	
Use a single required reserve ratio (LT). Use liquidity ratio regulations for prudential purposes, while reducing the reserve requirement gradually over time (LT). Remove the option of holding required reserves in treasury bills (ST). Gradually remove the limit of 50 percent on maximum usable reserves (MT).	**Partially implemented**. The liquidity ratios are used for prudential purposes and the reserve requirements were reduced. The treasury bills were removed as an option to meet the reserve requirements after the FSAP but were reinstated during the global financial crisis.
Reference the interest rate on liquidity maintenance credits to the relevant ECB rate (ST). Abolish interest charges for intraday credit and use automatic collateral system (MT).	**Not implemented**. The T-bill rate is benchmark for reference interest rate due to the fact that CBM does not have one. Collateral system procedure is simplified meanwhile.
Emergency Liquidity Support	
Establish a systemic crisis management framework and a strategy for emergency liquidity provision.	**Partially implemented**. Law on Financial Stability Council was adopted in year 2010 and Contingency Plan has been adopted. Refinements are needed.
Insurance Regulation and Supervision	
Further study supervisory architecture, taking into account the size of the Montenegro economy and financial sector trends.	**Implemented**. The Insurance Supervision Agency (ISA) has been established as independent legal person, directly responsible to the parliament.
Payment Systems	
Prepare and enact a Law on Payment and Settlement Systems. Include following topics: (i) irrevocability and timing of settlement finality for all types of payment instruments; (ii) legal recognition and protection of netting arrangements (in the context of insolvency); and (iii) the use of collateral pledges and clear provisions on the legal admissibility in a court of payment instructions, messages and transfers through electronic systems; (iv) e-based payment instruments.	**Implemented**. The Payment System Law passed by the parliament in December 2013 and is harmonized with relevant European directives covering the areas outlined in 2006 FSAP..
Start oversight of settlement and clearing systems for electronic payment instruments.	**Partially implemented**. An oversight division has been recently established in the CBM. However, the scope of the oversight function including oversight over electronic payment instruments is yet to be established.

2006 Main Recommendations	2015 Status Update
Provide leadership to develop national infrastructure for the electronic payment instruments. Technical parameters to enable sharing of the e-payments related infrastructure, such as the automated teller machines-ATM and the point-of-sale devices, should be established.	**Partially implemented**. The retail payment infrastructure includes a network of interoperable ATMs and PoS terminals, owned by the banks which are used for both credit and debit card transactions. There have been no CBM-led activities for developing any technical parameters for an interoperable infrastructure, as the existing infrastructure is already interoperable.
Registries	
Broaden access to credit registry (ST). Include additional information in credit registry to better appraise payment discipline (MT). Include statistics and information needed to implement credit models and scoring systems necessary for Basel II implementation (MT).	**Partially implemented**. The Credit Registry has been significantly improved. However, additional improvements could be made to expand the coverage, granularity, and timeliness of information collected and distributed.
Take credit registry out of off-site supervision and place it in a separate department in CBM.	**Implemented**. The Credit Registry has been moved from the off-site division to a special organizational unit.
Charge on cost recovery basis for provision of information and services. Broaden the range of services according to market needs.	**Partially implemented**. Services are charged pursuant to the "Decision on Determining Tariffs for Calculating Fees Charged for the CBM Services." Despite initiatives to expand range of services with other interested parties, these initiatives have not yet been implemented due to limitations on accessing personal information stemming from legislation (Law on Protection of Personal Data, etc.).
Study options to establish a centralized registry agency, which would include all existing registries.	**Partially implemented**. Discussions are ongoing to improve the exchange of information between different registries (register of commerce, tax authorities, etc.).
Capital Markets	
Evaluate consequences and needed changes in legislation, regulation and infrastructure moving from: (i) a "closed/domestic" market to an open market allowing cross border membership etc.; (ii) an "all on exchange" regime to allowing off-exchange/OTC trading.	**Partially implemented**. The draft Law on Capital Market contains provisions relating to the establishment of OTC trading, and will be followed by the adoption of by-laws to regulate in detail this area. Adoption of the draft law is scheduled for the fourth quarter 2015.
Move both stock exchanges to one common trading platform. Reorganize market/listing structure.	**Implemented**. As of January 1, 2011, Montenegro Stock Exchange Podgorica began operating as a single stock exchange by merging Nex Stock Exchange Podgorica with Montenegro Stock Exchange ad Podgorica.
EU Convergence	
Establish a catalogue for adapting financial sector legislation and market practices and develop action plans in each area.	**Implemented**. The Government of Montenegro adopted "The Montenegro Accession Program 2014-2018," a strategic document for the process of Montenegro's accession to the EU. The program includes a plan for the harmonization of national legislation with the EU acquis, including on financial sector.
Legal Framework	
Provide legal protection for the CBM, its officers, staff and agents against liability for damages caused by such persons in the good faith performance of their duties.	**Partially implemented**. Protection is provided for any liability incurred by staff while carrying out their functions in good faith and in the absence of negligence. However, the legislation is silent on coverage for any omission made by staff while discharging their duties in good faith. Also, the legislation is silent on cover for the CBM itself.
Empower supervisors to impose appropriate remedial measures in individual situations.	**Implemented**. The Banking Act provides the CBM with a wide range of powers, ranging from the issue of written warning notices to the revocation of the banking license. In-between measures include requiring the bank to address the irregularities, increase own funds, desist from certain activities, remove a director or member of senior management, order the bank to sell part of its assets and appoint an interim administrator.

2006 Main Recommendations	2015 Status Update
Authorize the supervisors to impose monetary penalties directly without having to first obtain court approval.	**Not implemented**. The CBM does not have the power to impose monetary fines for misdemeanors (e.g. submitting inaccurate reports). If it wishes to impose a monetary fine it must go through the Court of Misdemeanors.
Creating precedent in judicial handling of criminal cases including regarding insider trading and other market abuses.	**Not implemented**. Abuse of privileged information and manipulation of the securities market and other financial instruments are defined as criminal offences by Criminal Procedure Code of Montenegro. No precedents created.